United States Court of Appeals

for the Second Circuit

APPELLANT'S BRIEF

ORIGINAL WITH PROOF OF SERVICE

74-1795

UNITED STATES COURT OF APPEALS

for the

SECOND CIRCUIT

GEORGE J. SCHONHOLTZ,

Plaintiff-Appellant,

-against-

AMERICAN STOCK EXCHANGE INC., RAMSAY RE, FARRELL, ROCHLIN & ERDMAN and BEAR STEARNS & CO.,

Defendants-Respondents.

ON APPEAL FROM THE UNITED STATES DISTRICT COURT FOR THE SOUTHERN DISTRICT OF NEW YORK

BRIEF OF THE APPELLANT

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IN THE
UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

No. 74-1795

GEORGE J. SCHONHOLTZ, Plaintiff-Appellant,

v.

AMERICAN STOCK EXCHANGE, INC.,
RAMSEY, RE, FARRELL, ROCHLIN
& ERDMAN and BEAR, STEARNS & CO., Defendants-Appellees.

Appeal from the United States District Court for the
Southern District of New York

BRIEF OF THE APPELLANT

QUESTION PRESENTED

Does the Complaint allege with sufficient particularity a claim for relief against defendants .

STATEMENT

Plaintiff, a physician, sold short on August 4 and 11, 1971, 200 shares of the common stock of Levitz Furniture (Levitz). On August 17, 1971, plaintiff covered his short sales by purchases at prices substantially above those of his earlier sales (A-3). Unbeknownst to plaintiff, at the time of the above transactions, a corner had developed in Levitz stock. As a result of the corner, trading in Levitz was erratic, accompanied by sharp upward price movements unrelated to economic and ordinary market factors (A-7;A-15-16). Subsequent investigation revealed that concentrated purchases by large institutions had aroused public interest in Levitz stock and caused a sharp appreciation in its price (A-15-16). The combination of institutional purchases and stepped up buying by the public depleted the available float in Levitz stock. Since there was an unwillingness to sell Levitz stock by the institutional holders, the scarcity of stock available persisted for some time.

The condition described above presented an ostensibly attractive situation for short sellers who were

unaware of the pitfalls inherent in any short sale transaction in Levitz stock. Short selling often results in a correction of the market price of a security which has been trading at an artificially high level. However, where as in this case, the artificially high price is the direct product of an absence of supply, the combination of circumstances presents a classic trap for short sellers.

Levitz stock, at the time of plaintiff's short sales and covering transactions, was traded on the American Stock Exchange. The specialist assigned the duty of maintaining a fair and orderly market in Levitz stock was Ramsey, Re, Farrell, Rochlin & Erdman (Ramsey, Re), a brokerage firm under the direct control of Bear, Stearns & Co. (Bear, Stearns). The American Stock Exchange (Amex), Ramsey, Re and Bear, Stearns are the defendants in this action.

The complaint alleges that the defendants failed in their duty to maintain a fair and orderly market in Levitz stock. Ramsey, Re and Bear, Stearns, its controlling parent, have the responsibility to supply stock in amounts sufficient to maintain price continuity and eliminate sharp price fluctuations. Should they lack the ability to meet such

responsibility, trading should be halted.* The complaint alleges that these defendants failed to take any action directed towards the maintenance of an orderly market in Levitz stock and failed to disclose the dangerous trading conditions resulting from such failure to the investing public.

The Amex represents to the investing public that its securities market will have a continuity and fluidity consistent with the public interest and activity. In order to insure such conditions, the Amex must engage in constant market surveillance over the stocks traded thereon. The specialist's records are available for inspection and any persistent, unusual price fluctuation should inspire an inspection of such records and a consultation with the specialist to determine the cause thereof. The complaint alleges that the Amex failed to exercise either surveillance or supervision over the specialist. (A-7-8). As a result of its failure to enforce its rules, the continuity and fluidity in Levitz stock was severely interrupted for a substantial period of time, and short-sellers, such as plaintiff, sustained heavy losses.

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* Report of Special Study of Securities Markets of the Securities and Exchange Commission, H.R. Doc. No. 95, 88th Cong., 1st. Sess., part 2, at p. 125 (hereinafter referred to as Special Study).

The District Court, on motion by defendants, dismissed the complaint. It held that "even assuming the trading in Levitz stock was hectic or even dangerous, plaintiff points to no recognized legal duty on the part of any of defendants to disclose that fact." (A-21).

Plaintiff contends that the District Court erred in exonerating the defendants from liability for their failure to prevent the development of a "hectic and dangerous market,"to warn investors of its existence and to take steps designed to counteract its effect.

ARGUMENT

THE COMPLAINT STATES A VALID CLAIM FOR RELIEF UNDER THE EXCHANGE ACT AND STOCK EXCHANGE RULES

Plaintiff submits that he has pleaded a valid cause of action against the defendants for violation of the Securities Exchange Act of 1934 (Exchange Act), Rule 10b-5 promulgated thereunder and Rules 170 and 177 of the American Stock Exchange. Each violation will be separately discussed below.

A. Claim Against Defendant Amex for Violation of Section 6 of the Exchange Act.

In order to fulfill the objectives of the Exchange Act "it is the duty of the [federal] courts to be alert to provide such remedies as are necessary to make effective the congressional purpose". J.I. Case Company v. Borak, 377 U.S. 426, 433,84 S.Ct. 1555, 1560, 12 L.Ed. 2d 423 (1964); Deckert v. Independence Shares Corporation, 311 U.S. 282, 61 S. Ct. 229, 85 L.Ed. 189 (1940). The Exchange Act was enacted to prevent a recurrence of a stock market situation at the mercy of "bear raids" and "pooling" operations. The statute was impelled by investigations which revealed that

the exchanges tolerated practices[*] which "menace[d] the true functioning of the exchanges, upon which the economic well-being of the whole country depends."[**] A purpose of the Act was to provide "for the self-regulation of the business practices of stock exchanges and their members to the end that fair and honest markets are kept available to those engaged in the purchase and sale of securities." Cowen v. New York Stock Exchange, 256 F. Supp. 462 (N.D.N.Y. 1966). The Act envisaged a system of exchange regulation which was "drastic" and "direct".[***]

Although the Securities Exchange Commission (SEC) has, under the Exchange Act, certain direct rulemaking powers with respect to practices on the exchanges, the Commission has encouraged the concept of self-regulation and has chosen "to suggest the adoption of rules by the exchanges themselves". Thus, self-regulation is "an important and integral part of the regulatory pattern for the securities markets".[****]

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* See, Report of the Committee on Banking and Currency, "Stock Exchange Practices", Senate Report No. 1455, 73rd Cong 2d Sess. (1934).

** H.R. Rep. No. 1383, p. 11, 73rd Cong. 2d Sess. (1934).

*** 2 Loss, Securities Regulation 1167 (2d Ed. 1961).

**** Special Study No. 95, Part 5, p.197, 198 (1963).

To implement the legislative policy of fair and orderly markets, the Exchange Act required the registration of national securities exchanges with the SEC. The conditions precedent to such registration include:

> "An agreement ... to comply, and to enforce so far as is within [the exchange's] powers compliance by its members, with the provisions of this chapter, and any amendment thereto and any rule or regulation made or to be made thereunder. Sec. 6(a)(1).
>
> No registration shall be granted or remain in force unless the rules of the exchange include provision for the expulsion, suspension, or disciplining of a member for conduct or proceeding inconsistent with just and equitable principles of trade... Section 6(b).
>
> If it appears to the Commission that the exchange applying for registration is so organized as to be able to comply with the provisions of this chapter and the rules and regulations thereunder and that the rules of the exchange are just and adequate to insure fair dealing and to protect investors, the Commission shall cause such exchange to be registered as a national securities exchange." Sec. 6(d).

The import of Section 6 is clear. "National Securities exchanges" are required to "enforce so far as is within [their] powers" compliance by their member firms with the provisions of the Securities laws. Since Congress provided for the delegation of such authority to the exchanges,

the latter have the clear responsibility to pursue that charge, which includes "expulsion, suspension or disciplining of a member for conduct or proceeding inconsistent with just and equitable principles of trade". The case of Silver v. New York Stock Exchange, 373 U.S. 341, 351 (1963) makes clear that a "private club"* atmosphere, with its attendant tendencies of exchanges to eschew self-regulation, can no longer be reconciled to the demands and risks of a national economic and financial system:

> "As exchanges became a more and more important element in our Nation's economic and financial system, however, the private-club analogy became increasingly inapposite and the ungoverned self-regulation became more and more obviously inadequate, with acceleratingly grave consequences. This impotency ultimately led to the enactment of the 1934 Act. The House Committee Report summed up the long-developing problem in discussing the general purposes of the bill:
>
> 'The fundamental fact behind the necessity for this bill is that the leaders of private business, whether because of inertia, pressure of vested interests, lack of organization, or otherwise, have not since the war been able to act to protect themselves by compelling a continuous and orderly program of change in methods and standards of doing business to match the degree to which the economic system has itself been constantly changing..... The repetition in the summer of 1933 of the blindness and abuses of 1929 has convinced a patient public

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* Stock exchanges were originally voluntary associations, which allegedly evolved into private clubs. See Belton v. Hatch, 109 N.Y. 593 (1888).

> that enlightened self-interest in private leadership is not sufficiently powerful to effect the necessary changes alone - that private leadership seeking to make changes must be given Government help and protection.' H.R. Rep. No. 1383, supra, at 3.
>
> It was, therefore, the combination of the enormous growth in the power and impact of exchanges in our economy, and their inability and unwillingness to curb abuses which had increasingly grave implications because of this growth, that moved Congress to enact the Securities Exchange Act of 1934. S. Rep. No. 792, 73rd Cong. 2d Sess. 2-5 (1934)".

The Court in Silver stressed the vital importance of exchange rules in the overall scheme of securities regulation and regarded such services as embodying "duties created" under the 1934 Act. The court found that rules governing the conduct of exchange members constituted "one aspect of the statutorily imposed duty of self-regulation." The Court stated with respect to the exchange rules involved in that case:

> "The Exchange's constitutional provision and rules relating to private wire connections are unquestionably part of this fulfillment of the §6(b) and §6(d) duties.... In light of the important role of exchanges in our economy and the 1934 Act's design of giving the exchanges a major part in curbing abuses by obligating them to regulate themselves, it appears conclusively - contrary to the District Court's conclusion - that the rules applied in the present case are germane to performance of the duty, implied by §6(b) and §6(d), to have rules governing members' transactions and relationships with non-members." p. 355-356.

It ruled that those "instances of exchange self-regulation which fall within the scope and purposes of the Securities Exchange Act" were of sufficient importance to justify exemption from the anti-trust laws.(p.361).

The importance of exchange self-regulation in the effective protection of investors under the Exchange Act was recognized by this Court in Baird v. Franklin, 141 F. 2d 238 (2d Cir. 1944), cert. denied 323 U.S. 737 (1944), which held that failure by a stock exchange to enforce rules adopted pursuant to §6(b) may give rise to a federal claim against the exchange by an investor injured as a result thereof.

In Baird, the New York Stock Exchange breached the duty created by §6 in failing to discipline a member-broker who misused his customers' securities. That breach of duty by the Exchange was held not to constitute the cause of the plaintiffs' injury (Justice Clark dissenting), but both Judge Clark and Augustus Hand, who wrote for the majority, agreed that a private cause of action against the Exchange could be based upon a violation of duties prescribed by §6.

The pertinent parts of the Baird decision which have been widely followed are found in Judge Clark's dissenting opinion and deal with the issues upon which the entire court agreed. Judge Clark stated:

"Sections 6(b) and (d) were surely intended to be read together, and the latter makes it clear that the purpose of the requirements of the former is "to insure fair dealing and protect investors." This can be realized only if §6(b) is construed as imposing the twofold duty upon an exchange of enacting certain rules and regulations and of seeing that they are enforced.

* * *

"If these aims are to be followed by the Act, then, if the investing public is to be completely and effectively protected, §6(b) must be construed as granting to injured investors individual causes of action to enforce the statutory duties imposed upon the exchanges. (pp. 244-245).

Following Baird, federal courts have consistently maintained that national securities exchanges are required by §6 to enforce their own rules and have not been hesitant to recognize individual cause of action against securities exchanges for violation of the duties imposed by that Section. In Pettit v. American Stock Exchange, 217 F. Supp. 21 (S.D.N.Y. 1963), trustees of the bankrupt Swan-Finch Oil Corporation sued the Amex for failing to enforce its rules, alleging that such failure to carry out its duty under §6 allowed members of a conspiracy to effectuate an illegal and fraudulent distribution of Swan-Finch stock to the public. "Vital participants" in this conspiracy were Gerard A. and Gerard F. Re who, as the specialists in Swan-Finch stock, "engaged in transactions in Swan-Finch shares far beyond the limited scope of activity allowed specialists in connection with the maintenance of a fair and orderly market." (p.24). The district court accepted without discussion the adequacy of a complaint against the Exchange based upon Section 6.

In Kroese v. New York Stock Exchange, 227 F. Supp. 519 (S.D.N.Y. 1964), Bright v. Philadelphia-Baltimore-Washington Stock Exchange, 327 F. Supp. 495 (E.D. Pa. 1971) and Weinberger v. New York Stock Exchange, 335 F. Supp. 139 (S.D.N.Y. 1971)*, federal courts have recognized a cause of action against securities exchanges for violating or failing to enforce exchange rules.

Further, the cases make clear that such a cause of action can be based upon a negligent violation of §6. In Baird, Judge Clark stated that §6 imposed a duty upon the Exchange to take disciplinary action against its members for violations of the Exchange Act or of the exchange rules "which it either knew of or at least had reasonable cause to suspect." (p.244). In the first sentence of Judge Hand's opinion, he enunciated a similar standard:

> "We accede to the view that the Stock Exchange violated a duty when it failed to take disciplinary action against Richard Whitney on November 24, 1937, after there was reason to believe that the latter had converted the plaintiffs' securities (p.239). [Emphasis added].

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* In Weinberger, the Court cited Baird for the proposition that Congress intended to create a private right of action against securities exchanges and that the "liability of the Exchange ... flow[s] from a breach of its statutory duty to regulate its member firms." (pp. 244, 245). The statutory basis for implying a federal cause of action for breach of stock exchange rules can be found in the authority of federal courts under §27 of the Exchange Act to enforce any duty "created by" said Act. Buttrey v. Merrill, Lynch, Pierce, Fenner & Smith, Inc., 410 F. 2d 135 (7th Cir. 1969) cert. denied 396 U.S. 838 (1969).

As the court stated in Pettit, supra, about Baird, though the New York Stock Exchange had knowledge of Whitney's violations,

> [N]either Judge Augustus Hand, writing for himself and Judge Swan, nor Judge Clark, in dissent, were willing to restrict Section 6 liability to cases of actual knowledge ... These statements clearly recognize a cause of action for negligent violation of Section 6. pp. 29-30.

The court in Pettit thereby explicitly rejected the defendant American Stock Exchange's argument that "liability arises only when it has notice of the violations of its members."

In view of the acceptance by the courts of the negligence standard with respect to violations of §6, plaintiff has pleaded a valid cause of action, alleging that the Amex knew or should have known that Ramsey, Re failed to perform its duty to maintain a fair and orderly market and that the Amex failed to supervise Ramsey, Re in the performance of such duty.

The court below failed to discuss or specifically rule upon the Amex's alleged violation of §6 of the Exchange Act. However, it dismissed plaintiff's claims

"arising out of the alleged violations of exchange rules" which impliedly include the failure to enforce such rules. The court stated that "[e]ven assuming that Amex rules were violated", the courts have not "found an implied right of action for the violation per se of an exchange rule." The court failed to mention Baird and cited in support of its dismissal Colonial Realty Corp. v. Bache & Co., 358 F. 2d 178 (2d Cir. 1966), and other cases specifically relating to the issue of jurisdiction over exchange members.

Significantly, the court below avoided the issue of whether a failure to enforce Amex Rules 170 and 177 would support an implied right of action, curiously holding instead that since plaintiff had failed to state a 10b-5 claim, his remaining allegations concomitantly failed. Plaintiff submits that the decision of the court is in error and that his allegations of the failure to enforce Amex Rules 170 and 177, which are discussed more fully below, set forth a valid cause of action under §6.

B. Claim Against Ramsey, Re for Violation of American Stock Exchange Rules 170 and 177.

Contrary to the holding of the court below, the complaint alleges with reasonable specificity allegations of fact sufficient to constitute an actionable violation of Stock Exchange rules. Plaintiff has alleged a violation of Amex Rules 170 and 177. In paragraph 1, he alleges a violation of these rules as a basis for the court's jurisdiction. In paragraphs 5 and 6, he alleges facts as to the nature of the violations: in paragraph 5, he alleges that the specialist (defined in paragraph 2(iii) as Ramsey, Re) had the responsibility to ensure that members of the public can buy and sell securities at prices free from the price fluctuations caused by an inadequate floating supply of stock. In paragraph 6, plaintiff alleges that for almost two years the defendants knowingly permitted an inadequate supply of Levitz stock to persist, resulting in trading at artificially high prices.

Thus, plaintiff alleges a violation of the specialist's duty to permit trading only in those securities in which an orderly market exists. The heart of the complaint in this case is that price movements in Levitz stock were being artificially controlled due to the inadequate float, and Ramsey, Re, having failed to maintain a fair and orderly market, was under a duty to report such failure and suspend trading in the stock.

Rule 8(a)(2) FRCP calls for a "short and plain statement of the claim showing that the pleader is entitled to relief."* For purposes of the motions before the Court, the factual allegations of the complaint are to be taken as true. Smith v. Sperling, 354 U.S. 91 (1957). Furthermore, the complaint must be"liberally construed in favor of plaintiff". Jenkins v. McKeithen, 395 U.S. 411 421 (1969); Bush v. Bruns Nordeman & Co., 1972-1973 Transfer Binder, CCH Fed. Sec. L.Rep. ¶93,674. Finally, the complaint should not be dismissed unless it appears that plaintiff "could 'prove no set of facts in support of his claim which would entitle him to relief'". Jenkins v. McKeithen, supra, at 422, citing Conley v. Gibson, 355 U.S. 41, 45-46 (1957). See also Goldstein v. North Jersey Trust Co., 39 FRD 363 (S.D.N.Y. 1966).

Proof of the facts alleged herein would entitle plaintiff to relief since it is now established that a private right of action may be maintained against a party other than an exchange for violation of certain exchange rules. Buttrey v. Merrill,Lynch,Pierce, Fenner & Smith,Inc.,supra. In the Buttrey case, a violation of N.Y.S.E. Rule 405 was held to be actionable and in reaching its decision the court applied the standard set

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* In Bush v. Bruns Nordeman & Co., supra, the court found that the complaint in the action met the standard of Rule 8, even though some of the allegations were not detailed.

forth in Colonial Realty, supra, the first case to deal directly with the issue. In that case, Judge Friendly made clear that some exchange rules might "provide the basis for implying a private right of action" and outlined a mode of analysis for making that determination:

> "What emerges is that whether the courts are to imply federal civil liability for violation of exchange or dealer association rules by a member cannot be determined on the simplistic all or nothing basis urged by the two parties; rather the court must look to the nature of the particular rule and its place in the regulatory scheme, with the party urging the implication of a federal liability carrying a considerably heavier burden of persuasion than when the violation is of the statute or an SEC regulation. The case for implication would be strongest when the rule imposes an explicit duty unknown to the common law." (p.182).

The court postulated that a stock exchange rule which amounted to "a substitute for regulation by the SEC itself" could form the basis of a federal cause of action. (p. 182).

The Court recognized that some rules impose only housekeeping duties which do not warrant federal enforcement, but asserted that rules which could "play an integral part in SEC regulation" could support a federal cause of action. The Court in Buttrey, supra, adopted the Colonial standard and held that the violation of a stock exchange rule was actionable where it "was designed for the protection of investors" and "plays an integral part in SEC regulation". (p. 142). The

Seventh Circuit further held that a rule designed for the protection of investors was presumably actionable and that the allegation of a violation thereof could survive a motion to dismiss.

Plaintiff contends that the rules allegedly violated herein fall within that category of rules whose breach gives rise to a private cause of action, since the reasons behind their enactment justify their use as a basis for implying liability. Rules 170 and 177 were enacted for the direct protection of the investing public and, accordingly, the public has interests thereunder which justify judicial protection.

In attempting to classify exchange rules, attention should be given to the role played by the rule in the exchange's regulation of the securities market. Silver v. New York Stock Exchange, supra. The rules allegedly violated in this action are not mere housekeeping rules, but rather rules which are essential to exchange regulation. They concern the conduct of specialists who, according to G.B. Funston, former president of the New York Stock Exchange, provide "the guts of the whole market system".* Stock exchanges, although so termed, are not free and open auction

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* Wall Street Journal, July 11, 1961, p. 1

markets with prices determined by the unassisted operation of the law of supply and demand, but rather involve a highly regulated system with the specialist at its core, acting in a managing capacity. One commentator has gone so far as to state that "investors must buy when and at what prices specialists choose."*

Rules 170 and 177 of the Amex which regulate specialists are required by Section 6(a)(3) to be filed with the SEC, must comply with the requirement of 6(d) that they be "just and adequate to insure fair dealing and protect investors" and were implemented in response to the joint command of section 11(b) of the 1934 Act (15 U.S.C. §78K (b)) and the SEC rule thereunder, 11b-1 (17 C.F.R. §240-11b-1). They impose explicit duties on specialists which are mandated by federal statute and regulations and do not merely repeat broad common law obligations.

Section 11(b) of the Exchange Act gives to the SEC direct rule making powers in respect to specialists' practices on the exchange. It provides that rules of a securities exchange may permit members to be registered as specialists and act as dealers, but such rules must restrict the specialists' dealings "so far as practicable to those

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* Ney, The Wall Street Gang, Praeger Publishers, 1974, p. 115.

reasonably necessary to permit him to maintain a fair and orderly market." Section 11(b) also declares unlawful the disclosure by the specialist of information regarding his dealings which is unavailable to all members of the exchange. Thus, the Exchange Act imposes a negative duty on specialists to refrain from all dealings except those necessary for the maintenance of a fair and orderly market.

This negative duty stood alone until the promulgation of Rule 11b-1 by the SEC in 1965. Rule 11b-1(a)(2) requires the rules of a securities exchange to include 5 items if the exchange allows specialists to act as dealers: (1) minimum capital requirements (2) an affirmative duty on the specialist to engage in dealings for his own account to assist in the maintenance of a fair and orderly market (3) a negative duty on the specialist to restrict such dealings to those necessary to maintain a fair and orderly market (4) the responsibilities of a specialist acting as a broker and (5) procedures providing for continuous surveillance of specialists' activities. In addition to imposing a new affirmative duty upon the specialist, 11b-1(a)(2)(ii) requires exchange rules to provide that a failure to engage in such dealings will lead to suspension by the exchange.

Rule 11b-1 was implemented as a direct result of recommendations made by the SEC Special Study, part 2, pp. 57-171 (1963). That study dealt primarily with the role of the

specialist on the New York Stock Exchange but applies in general to the specialists' role on the Amex and other national exchanges.

Rules 170 and 177 of the American Stock Exchange reflect the requirements outlined by the SEC in Rule 11b-1. These rules provide in pertinent part:

AMEX Rule 170:

> "(a) No member shall act as a specialist in any security unless such member is registered as a specialist in such security by the Exchange and such registration may be revoked or suspended at any time by the Exchange.
>
> (b) As a condition of a member's being registered as a specialist ... it is to be understood that ... [he] is to engage in a course of dealings for his own account to assist in the maintenance, insofar as reasonably practicable, of a fair and orderly market ... If the Exchange shall have found any substantial or continued failure by a specialist to engage in such a course of dealings, the registration of such specialist shall be subject to suspension or cancellation by the Exchange....
>
> * * *
>
> (d) ... it is ordinarily expected that a specialist will engage, to a reasonable degree... in dealings for his own account in full lots when lack of price continuity or lack of depth ... or temporary disparity between supply and demand ... exists or is reasonably to be anticipated ...."

AMEX Rule 177:

> "Every specialist shall report to a Floor Official:
>
> (a) Any unusual activity or price change in a security in which he specializes;

(b) Any information which he receives which he believes may affect materially the ... market in a security in which he specializes;

* * *

(d) Any unusual transaction or transactions in which he participates as a broker or as a dealer in the security in which he specializes."

An examination of the accepted meanings of the words "fair" and "orderly", contained in Rule 170, reveals that the specialist is under a general duty to help maintain a fair and orderly market, in the performance of all his activities. In The Regulation of Stock Exchange Members,* an early work which dealt with the function of specialists, R. Vernon gave the following definitions:

> " A fair market... bears the connotation of a market in which the individual investor need not fear for the integrity of his broker, the safety of his funds or the possibility that such movements are being artificially controlled.
>
> An 'orderly' market is regarded as one in which there are no 'sudden and unreasonable fluctuations in the sales of securities,' and consequently a market which makes no unnecessary adverse contribution to the stability and well being of the public at large."
> p. 132

Vernon's definitions are substantially similar to those given by the SEC in its Special Study, supra:

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* Vernon, The Regulation of Stock Exchange Members, New York, Columbia University Press (1941)

"'Fair' and 'honest' presumably encompass the notion of freedom from manipulative and deceptive practices of all kinds and may be regarded as positive expressions of the Act's ban on such practices, acts, and devices. (p.14) 'Orderly' presumably implies efficiency and economy of operations, but also embraces concepts of regularity and reliability of operation - "A market which does not 'fold up' when the pressure on dealers becomes too heavy" and the concept of avoidance of wide price swings within relatively short spans of time." (p.15)

In the light of the above definitions it is apparent that an obligation is imposed upon the specialist to maintain a fair and orderly market in all his activities, including his brokerage and reporting duties. In addition, these definitions satisfy the second part of Judge Friendly's test in <u>Colonial Realty</u>: that an actionable rule not be a catch-all provision such as "just and equitable principles of trade". The words "fair and orderly" place specific duties upon the specialist to help maintain a market free of artificial controls, deceptive devices and wide price fluctuations. These terms do not proscribe a wide variety of activities including merely unethical ones, but rather impose specific obligations on the specialist which were unknown to the common law.

The SEC has itself pointed out:

"...Commission Rule 11b-1 and [NYSE] Rule 104 reflect the intent of Congress that the specialist operate under rigorous standards. These standards are especially significant

since the specialist has no competitors on the floor of the Exchange in the stocks in which he specializes. As long as the specialist continues in his privileged position it is imperative that adequate performance standards are applied to make up for the lack of competition." *

This reference to Rule 11b-1 clearly illustrates "the integral part in SEC regulation" which the rules regarding specialists were designed to play, indicating that a violation of Rules 170 and 177 gives rise to a private cause of action.

Thus, plaintiff's allegations of a violation by Ramsey, Re of Amex Rules 170 and 177, set forth a valid claim. Further, his allegation that defendant knew or should have known of the inadequate supply of Levitz stock constitutes a charge of more than mere negligence and meets the exacting standard of Buttrey. Allowing a private federal cause of action against a specialist who fails to take required action and to report information which he knows or should know, and which is material to his and the exchange's duty to help maintain a fair and orderly market, does not make the specialist liable for mere errors in judgment or an insurer of his customers' investments. Rather it holds him to the same standard which is applied to the exchanges, themselves, in actions arising from violations of exchange rules.

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* Letter from Sheldon Rappaport to J. William O'Reilly, July 7, 1971, Securities Industry Study, report of the Subcommittee on Securities, Committee on Banking, Housing and Urban Affairs, S. Doc. No. 93-13, 93rd Cong. First Ses., part 4, p. 38 (1973).

C. Claims Against All Defendants For Violations of Rule 10b-5.

Plaintiff contends that the defendants violated Rule 10b-5 in not disclosing that, at the time of plaintiff's purchase, the supply of Levitz common stock was inadequate to insure a fair and orderly market. The court below correctly interpreted plaintiff's complaint to plead defendants' omission to state a material fact. The court stated:

> "Plaintiff's claim boils down to the assertion that defendants impliedly represented to the public that there was an adequate floating supply of Levitz stock; that plaintiff relied on this representation; that the floating supply was actually "inadequate" (Paragraph 8); that price movements in the stock were accentuated as a consequence; and that defendants were under a duty to disclose these facts and halt trading in the stock (Paragraph 8)." (A-19-20).

However, the court concluded that plaintiff had failed to state a 10b-5 claim against the defendants, stating that even though trading in Levitz stock was "hectic or even dangerous, plaintiff points to no recognized legal duty on the part of any of the defendants to disclose that fact, or any action or omission by defendants which amounted even to negligence, much less securities law fraud." (A-21). Plaintiff contends that

this holding is erroneous in that it fails to recognize the legal duty of and the culpable omissions and acts by the defendants.

I. Legal Duty

The courts have consistently required a higher standard of care where a defendant in a 10b-5 action has a fiduciary obligation to the plaintiff and have considered important a special relationship between the parties imposing a duty to affirmatively disclose material facts. See, e.g. Vine v. Beneficial Finance Co., 374 F.2d 627 (2d Cir. 1967), cert. denied 389 U.S. 970 (1967). Disregard of a duty to speak created by such relationship is actionable. In the instant case, both the defendants Ramsey, Re and the Amex had a duty to speak.

a. Ramsey, Re's Duty

The specialist is a fiduciary with duties and responsibilities toward the investing public. In 1936, the SEC recognized the special position of the specialist:

> "The specialists occupy the pivotal position in the market for the stocks in which they specialize. As buyers and sellers for their own account or as agents in the execution of orders for others, specialists actually purchase and sell a substantial percentage of all stock traded in on the exchange and actually participate in a great majority of all trades. Even with respect to those transactions in which they are not parties

their bids and offers serve as standards for the appraisal of the market by others."*

In 1962, the Commission reaffirmed the fiduciary nature of the specialists' function. It stated:

> "It has long been recognized that the unique position of the specialist in the center of the exchange markets carries with it correlative responsibility. The specialist is permitted and even expected to trade for his own account and risk in the securities in which he is registered as a specialist. He also functions as a broker executing orders entrusted to him by other brokers on behalf of their customers in the securities in which he specializes. Thus, he is in a position of trust and confidence with his customers and obligated within the terms of his agency to the strict standards of loyalty, disclosure and fair dealing required of fiduciaries. In his dual role the specialist has continuous and intimate contact with the markets in the securities in which he specializes, so that he is able to become uniquely familiar with circumstances and phenomena affecting their price and market performance. Possession of the confidential information in his "book" reflecting the unexecuted orders of other members and their customers gives him a further advantage in dealings for his own account." In the Matter of Re, Re & Sagarese, Securities Exchange Act Release No. 6900 (9/21/1962), 1962 Fed. Sec. L. Rep. ¶76,868.

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* U.S. Securities and Exchange Commission, Report on the Feasibility and Advisability of the Complete Segregation of the Functions of Dealer and Broker. Washington, Government Printing Office, p.25 (1936).

Further , the Commission stated that specialists have fiduciary obligations, requiring "loyalty, disclosure and fair dealing". It concluded that "the behaviour of those who perform vital functions in the operation of the nation's securities markets must be judged by standards designed to provide maximum protection for the investing public."

The specialist is expected to maintain a continuous and orderly market, trading his own account whenever necessary. His major duty is "filling in gaps in supply and demand" and "[s]pecialists thus play a vital role in keeping price changes between transactions narrow and in maintaining the broad liquidity of exchange markets."* Specialists are also required to report material information with respect to supply which would affect market operations.

Plaintiff alleged that for a period of almost two years, "the common stock of Levitz traded on the Amex at artificially high prices created by a limited and inadequate

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* By consulting his "book" which is legally "secret", the specialist is able to make a reasonably accurate estimate of the supply and demand balance of his stock. In addition, he is often privy to inside information furnished by corporations of whose stock he is specialist. Thus, the specialist has unique access to information legally unavailable to others and is under a duty to report such information where he believes it may affect materially the market in the security in which he specializes.

supply of Levitz stock", a fact which was or should have been known to defendants." Thus, defendant Ramsey, Re failed in its responsibility to ensure the stability of the exchange market and breached its fiduciary responsibility to plaintiff and the investing public in failing to make known that there was an inadequate trading supply of Levitz stock.

b. Conduct by Ramsey, Re which Amounts to an Actionable Violation of Rule 10b-5

By permitting trading in Levitz stock to continue without disclosure of the paucity of supply, Ramsey, Re "impliedly represented to the public that there was an adequate floating supply of Levitz stock" and its failure to reveal the falsity of that representation resulted in a material misrepresentation. As discussed above, plaintiff has alleged that for a period of almost two years, Ramsey, Re failed to perform its function as a specialist in violation of Rules 170 and 177. Although such failure for a short period might be unavoidable and unworthy of disclosure unless of serious proportions, plaintiff contends that such a prolonged shortage of Levitz stock and a concomitant failure by defendant to reveal such shortage evidences an abandonment by Ramsey, Re of its responsibility to the investing

public or, at the least, negligence of a character sufficiently gross to invoke the protection of Rule 10b-5.

The "implied representation" theory rejected by the court below has been accorded approval by this court. The landmark case of Charles Hughes & Co. v. SEC, 139 F. 2d 434 (2d Cir. 1943), *cert. denied* 321 U.S. 786 (1944), held that a broker-dealer impliedly represents that the price of securities asked of a purchaser "is close to the market". The court stated: "The law of fraud knows no difference between express misrepresentation on the one hand or concealment on the other." p. 437. The implied representation or "shingle" theory requires the broker dealer, because of his fiduciary status, to make certain basic disclosures.

Plaintiff believes that the implied representation theory, widely used in federal securities regulation, provides a suitable vehicle for the incorporation into Rule 10b-5 of self-regulatory requirements enacted for the protection of investors and the integrity of the securities markets.

In addition to violating Rule 10b-5 by its implied misrepresentation, defendants' covert failure to observe the responsibility imposed upon it as a quasi-public servant to "maintain an orderly market" for a period

of approximately two years, resulting in trading which was "dangerous" constituted a course of business which operated as a deceit upon plaintiff in connection with his purchase of Levitz stock.

Plaintiff has made no allegation that defendant Ramsey, Re profited from its course of conduct, solely because information with respect to such conduct is legally secret and in the hands of the defendants. However, plaintiff believes that this court should consider the basic conflict existing in certain circumstances between the specialists' responsibility to maintain an orderly market and his own profit making interests:

> "The combined functions of the specialist, acting as he does for the orders entrusted to him and for his own account as principal, involve an inherent conflict of interest. Furthermore, he acts for customers on both sides of the market, and he also has a responsibility to act on behalf of the market as a whole. In view of the benefits which responsible dealer activities can confer on the market, this conflict is tolerable, but only under a regulatory system which contains effective controls." Special Study, Part 2, p.165.

In view of the outrageous conduct of Ramsey, Re, the inherent conflict in its concealed activities as a specialist and the clear possibility of abuse in connection

therewith, plaintiff believes that he should be afforded full disclosure as to any benefits received by Ramsey, Re in connection with its trading of Levitz stock during the relevant period before a determination of a motion to dismiss.

However, an allegation of profit or knowing fraud is not necessary in order to establish a 10b-5 claim, since plaintiff has charged more than ordinary negligence. The element of scienter* has been accorded lessened significance in cases where the parties stand in a fiduciary relationship. Superintendent of Insurance of the State of New York v. Bankers Life and Casualty Co., 404 U.S. 6 (1971) illustrates the significant expansion of Rule 10b-5 into the area of non-traditional fraud, i.e. the fiduciary breach situation.

"Intent to defraud is not an indispensable element in a private action for damages under the anti-fraud provisions of the federal securities laws." Chris-Craft Industries v. Piper Aircraft Corp., 480 F.2d 341, 369 (2d

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* Some cases suggest that a misrepresentation under 10b-5(b) is per se actionable. See, e,g, Texas Continental Life Ins. Co. v. Bankers Bond Co., 187 F. Supp. 14, 23 (W. D. Ky. 1960), rev'd. on other grounds 307 F.2d 242 (6th Cir. 1962); Stevens v. Vowell, 343 F.2d 374, 379 (10th Cir. 1965). However, other courts have been reluctant to impose such stringent liability.

Cir. 1973). What is required is a failure to discharge a duty of proper disclosure, "considering the totality of facts and circumstances". In the instant case the defendant Ramsey, Re has a special relationship which imposes an "affirmative duty" of disclosure and its knowing and reckless failure to discharge that duty violates Rule 10b-5. Chris-Craft Industries v. Piper Aircraft Corp., supra.

In Chris-Craft, the Court utilized a duty approach,* stating:

> "The initial inquiry in each case is what duty of disclosure the law should impose upon the person being sued. See Royal Air Properties, Inc. v. Smith, 312 F.2d 210,212 (9 Cir. 1962); Ellis v. Carter, 291 F.2d 270, 274 (9 Cir. 1961). In making this determination we should bear in mind that a major congressional policy behind the securities laws in general, and the anti-fraud provisions in particular, is the protection of investors who rely on the completeness and accuracy of information made available to them. See 1 Bromberg, Securities Law: Rule 10b-5, §7.1, at 14 (1971). Those with greater access to information, or having a special relationship to investors making use of the information, often may have an affirmative duty of disclosure. When making a representation, they are required to ascertain what is material as of the time of the transaction and to disclose fully "those material facts about which the [investor] is presumably uninformed and which would in reasonable anticipation, affect his judgment." Kohler v. Kohler Co., 319 F.2d 634, 642 (7 Cir. 1963).

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* The Ninth Circuit has recently rejected scienter, focusing instead on the duty of the defendant and allowing what it terms a "flexible standard." White v. Abrams, 1974 CCH Fed. Sec. L. Rep. ¶94,457 (9th Cir. 1974).

A knowing or reckless failure to discharge these obligations constitutes sufficiently culpable conduct to justify a judgment under Rule 10b-5 or §14(e) for damages or other appropriate relief against the wrongdoer. SEC v. Texas Gulf Sulphur Co., supra, 401 F. 2d at 854-55." (p.363)

Plaintiff submits that the application of Chris-Craft to the facts of this case indicates that an action under Rule 10b-5 has been pleaded.

c. Amex's Duty

"Self-regulation is the mainspring of the federal securities laws", Chris-Craft Industries Inc. v. Piper Air-Craft Corp., supra, p. 370. The self-regulation imposed upon securities exchanges which "perform an important function in the economic life of this country" plays an important role in providing investor protection. Silver v. New York Stock Exchange, supra. The duty of the Amex requires close surveillence and prompt affirmative action to investigage dereliction on the part of specialists and to reveal material information gained thereby to the public or suspend trading, if necessary.* The high standard of conduct imposed upon

* In attempting to show that sufficient stock to maintain an orderly market was available, the Court below referred to provisions for delisting securities where less than 150,000 shares are publicly held. The Court inferred that so long as more than 150,000 shares of Levitz stock were publicly held, the market in that security would be presumed to be orderly. Delisting requirements are inapplicable to the present case which involved a situation in which there was adequate public ownership of securities but inadequate supply to meet buying demand.

the exchange devolves from its self-regulatory duties and its superior access to data pertaining to the securities market in general and the activities of specialists in particular.

d. Conduct by Amex in Violation of Rule 10b-5

Plaintiff alleged that the defendant Amex is liable under Rule 10b-5 as an aider and abettor of Ramsey, Re. By its failure to enforce its rules and discipline Ramsey, Re for its prolonged misfeasance to reveal the consequences thereof, the defendant Amex aided and abetted Ramsey, Re in its misrepresentation and course of deceitful conduct. Brennan v. Midwestern United Life Insurance Co., 259 F. Supp. 673 (N.D. Ind. 1966), affd. 417 F.2d 147 (7th Cir. 1969).

Stock exchanges have long been aware of the conflict of interest and dangers inherent in the specialist system and their regulations have been devised specifically to meet such problems. However, regulations enacted are only as effective as their enforcement and enforcement by the Amex has been notoriously lax. The SEC, Staff Report on Organization and Regulation of Conduct of Members of American Stock Exchange (1962) concluded:

> "Specialists are at the heart of the problems of organization, management and disciplinary procedures of the Exchange. Their dominance of the administration of the Exchange, their overriding concern for expansion of business through new listings, the misuse of their fundamental role in the operation of a fair and orderly auction market, and the breakdown of regulatory and disciplinary controls over them -- all are part of a complex pattern of interlocking causes and effects. It is for this reason that any program of reform must concentrate heavily on the dominant role of the specialist." p.39.

However, despite the clear mandate of the SEC to conduct surveillance and supervision, the Amex failed to carry out that duty.

Recent broker-dealer supervision cases have established that an aiding and abetting allegation can be based successfully upon a broker's wilfull or reckless failure to maintain adequate supervision over its representatives. SEC v. First Securities Co. of Chicago, 463 F.2d 981 (7th Cir.) cert. denied, 409 U.S. 880 (1972). Thus, a brokerage firm which recklessly fails to maintain and enforce supervisory controls can be viewed as aiding and abetting one guilty of a 10b-5 violation.

Similarly, the Amex's failure to enforce its rules establishes liability. It tolerated a "hectic" market in Levitz stock for a period of two years and failed to take affirmative action to suspend trading when the failure of

Ramsey, Re to maintain an orderly market in Levitz resulted in the virtual elimination of available shares for trading. At best, Amex had an affirmative duty to investigate and disclose material facts with respect to Levitz stock to the investing public. By failing to do so it violated Rule 10b-5 as a principal. Chris-Craft Industries Inc. v. Piper Aircraft Corp., supra. At the least, it is liable as an aider and abettor. Brennan v. Midwestern United Life Ins. Co. supra.

D. Claims Against Bear,Stearns Pursuant to §20 of the Exchange Act.

Bear, Stearns controls Ramsey, Re and participated in the wrongful conduct charged therein. Plaintiff alleges that Bear, Stearns knew that a corner had developed in Levitz stock and failed to take appropriate steps to warn the investing public and to cause a suspension in trading until an orderly market could be achieved. Further, Bear, Stearns is charged with the failure to supervise Ramsey, Re's activities. These allegations, if proved, are sufficient to establish liability against Bear, Stearns, under §20 of the Exchange Act.

Section 20(a) of the Act (15 U.S.C. §78t(a)) deals with liabilities of controlling persons and provides:

> "Every person who, directly or indirectly, controls any person liable under any provision of this chapter or of any rule or regulation thereunder shall also be liable jointly and severally with and to the same extent as such controlled person to any person to whom such controlled person is liable, unless the controlling person acted in good faith and did not directly or indirectly induce the act or acts constituting the violation or cause of action."

Section 20(a) has been given broad treatment, which is consistent with the liberal rules of construction afforded the Securities Exchange Act to enable that statute to achieve its remedial purpose. SEC v. First Securities Co. of Chicago, 463 F.2d 981, 986-87 (7th Cir. 1972) cert. denied. 93 S. Ct. 85 (1972). Section 20(a) "has been interpreted as requiring only some indirect means of discipline or influence short of actual direction to hold a 'controlling person' liable." Myzel v. Fields, 386 F.2d 718, 738 (8th Cir. 1967), cert. denied, 390 U.S. 951 (1968); Strong v. France, 474 F.2d 747, 752 (9th Cir. 1973).

Plaintiff submits that if the Court should find that Bear, Stearns is a controlling person within the purview of Section 20, it may be found liable for the damages proven to result from Ramsey's alleged illegal conduct. Accordingly, a cause of action has been properly stated against the defendant Bear, Stearns.

CONCLUSION

The Congress made clear that disregard of trust relationships by those whom the law would regard as fiduciaries, are all a single seamless web. Hoff v. Sprayregen, 339 F. Supp. 369 (S.D.N.Y. 1971). Plaintiff has set forth a valid claim for breach of trust and dereliction of duty. Accordingly, the judgment of the court below should be in all respects, reversed.

Respectfully submitted,
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